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No. 76-635

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

UNITED STATES STEEL CORPORATION, *et al.* ON BEHALF OF THEMSELVES AND ALL PERSONS SIMILARLY SITUATED,
Appellants,

v.

MULTISTATE TAX COMMISSION, *et al., Appellees.*

On Appeal from the United States District Court for the Southern District of New York

REPLY MEMORANDUM OF APPELLANTS

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REPLY MEMORANDUM OF APPELLANTS

I

As in the court below, the respondents, in their motion to dismiss, seek to create the impression that the Multistate Tax Compact and the Multistate Tax Commission hardly exist and are at most a sort of phantom or wraith resting very lightly on the American fiscal scene. Like the thief found in the chickencoop, who called out "It's just us chickens," they seek to create

the impression that they can be overlooked—that the operations of the Multistate Tax Commission have no impact. To this end, the Commission has cast its rules and practices in the form of "advice" and "recommendations" in order to ward off attack.

Despite this protective phraseology, the Compact has in substance united twenty-one states and created an active regional organization empowered to conduct multistate audits pursuant to its own regulations.[1] This active regional organization—the Multistate Tax Commission—is, in fact, a powerful body, capable of transforming interstate taxation. It is not inconsistent to argue that it is also a body which provides inadequate standards of conduct and insufficient remedies to those it seeks to regulate. The Commission, in the guise of being a purely "advisory" body, denies itself only those powers which could aid multistate businesses desiring to protest its regulations, audits, and assessments.

II

Given the existence and operation of the Compact, and the absence of Congressional consent, appellants do not believe that the validity of this Compact was deter-

[1] These regulations often conflict with the duly adopted laws of the member states. While it may be true, as a technical matter, that these regulations do not formally bind the member states, it is equally true—and more important—that the regulations in fact have substantial force and momentum. The force of the regulations, coupled with the expense of litigation and the demands of the Compact states pursuant to the Commission's regulations and practice, produces great pressure to accept the result of the Commission's multistate audits.

The substantive effect of the Commission's regulations and practice is also demonstrated by the criticism of foreign governments, and has caused some countries to seek protection from the United States Department of the Treasury. (This foreign reaction is discussed in appellants' Jurisdictional Statement at pp. 23-4.)

mined by *New Hampshire* v. *Maine*, decided June 14, 1976. *New Hampshire* v. *Maine* involved a bilateral boundary dispute settled over two centuries earlier and requiring no present legal adjudication. The Multistate Tax Compact involves twenty-one western states [2] and an on-going administrative organization not directly responsive to any electoral body. Such an arrangement is fundamentally distinguishable from the one time, one place agreements involved in boundary cases.[3] The boundary cases are inherently limited in scope; they have not been formally qualified in this Court only because Congressional consent has been sought by many of the modern compacts treating complex issues and involving more than two states. Cf. The Oregon-Washington Columbia River Fish Compact involved in *Idaho, ex rel. Andrus, et al.* v. *Oregon and Washington*, No. 67, Original. No case in this Court has ever upheld the validity of a multistate compact lacking Congressional consent. A number of cases in the lower federal courts and state courts are awaiting this Court's decision in the present case.

[2] The attempt by the Commission to include associate states as part of the Compact is misleading. The Commission at one time resolved that all non-member states would be "associate members," and the Commission's present list of associate members includes states like Arizona, which oppose the Compact and have associated to monitor the operations of the Commission. No associate member participates in the Commission's multistate audit program.

[3] The Chairman of the Commission recognized the distinct nature of the Multistate Tax Compact in an address to the Western States Association of Tax Administrators in October of 1971, stating that, "Its [the Compact's] success is especially surprising when one considers that unlike some compacts . . . this compact is involved in a controversial subject matter, has an administrative body known as the Multistate Tax Commission and is activist in nature." This conference took place October 4-8, 1971, and the Chairman's remarks appear in the record below in Appellants' Affidavit in Opposition to Summary Judgment, p. 9.

III

The Commission asserts that appellant's jurisdictional statement is "replete with misstatements of fact." (Motion to Dismiss, p. 18.) Basically, the Commission contends that neither its rules nor practice call for full apportionment or combined reporting in the conduct of multistate audits. The Commission also suggests that its methods have not been criticized in Congress. Appellants disagree.

The Multistate Tax Commission met in 1969 to draft regulations to implement the Compact. The Fifth Annual Report of the Commission (p. 4) states that "[t]hose regulations had the effect of including in apportionable business income more income, including substantial portions of income from intangibles, . . ." This departure from traditional practice produced some protest, and a hearing was held by the Commission. According to the Fifth Annual Report (p. 4), "[t]he result was that, with minor exceptions, nearly all corporate income was considered to be apportionable, as opposed to allocable."

Appellants' discovery produced several statements by Mr. Corrigan and a proposed Commission resolution which indicated that the Commission recognized that full apportionment required an amendment to the Uniform Division of Income for Tax Purposes Act ("UDITPA"), but that the Commission decided instead to implement the concept through regulations and practice. The language of Commission Regulation IV.1.(a) (reproduced in Appendix A, *infra* p. 1a) reveals that most, if not all, income can be classed as apportionable business income, and appellants' discovery determined that full apportionment was used in numerous Commission multistate audits. In effect, the Commission is arguing only that its regulation still contains the term "non-business income," as well it might, given the Commission's knowledge of the statutory change it was effectuating through regulation. Appellants believe that this argument is specious, given the Commission's full knowledge that its rules and practice have in fact substantially eliminated the distinction between business and non-business income in Compact states.

The Commission further contends that its rules and practice do not call for combined reporting and use of the unitary business concept. Despite regulations which otherwise set up an interstate tax scheme, Commission Regulation IV.2(b)(2) ("Application Article IV: Combined Report") specifically provides that no part of that scheme shall preclude combined reporting. (This regulation is reproduced in Appendix B, *infra* p. 2a.) Appellants do not know whether this regulation was adopted in light of planned Commission audit practices, or whether such practices were fostered by this regulation, but the Commission has conducted numerous multistate audits employing combined reports and the unitary business concept. Frederick Cappetta, the Audit Coordinator for the Commission, stated in the Seventh Annual Report (p. 56) that such audits have been conducted, and stated that the Commission would continue to pursue combined reporting. Mr. Cappetta has also published a combined report and unitary business schedule of information used by the Commission in practice (Appendix C, *infra* p. 3a).

The Seventh Annual Report (p. 50) also includes a statement by Mr. Corrigan declaring the Commission to be the only appropriate body through which widespread use of combined reporting can be achieved. Actions speak louder than words, here as well as elsewhere, and Regulation IV.2(b)(2), the Commission's

unitary business schedule, the Commission's actual conduct in multistate audits, and the statements of Commission personnel should make it clear that the Commission's adherence to combined reporting and the unitary business concept is not "conjectural."

Finally, the Commission's interpretation of congressional action is misleading. For example, the House Reports of 1965 and 1966, cited by the Commission as supporting full apportionment and combined reporting, in no way endorse the methods of the Commission. The full apportionment suggested was based on a two factor formula which eliminated the possibility of taxing "nowhere" income, and otherwise differed substantially from the Commission's methods. Both full apportionment and combined reporting were to be permitted only under the control of the federal government. Specifically, the House Reports recommended that the United States Treasury issue regulations and uniform returns to govern interstate taxation, with the Secretary of the Treasury as the final authority over interstate tax disputes. This sweeping reform was suggested because of the potential for duplicative taxation, burdensome assessment procedures, and other mismanagement inherent in multistate taxation controlled by the states. The Commission's favorable reference to H.R. 11798, 89th Cong., 2d Sess. (1966), the bill incorporating the recommendations of the Reports, is particularly misleading, since it was adverse reaction to this bill which caused the states to convene to form the Multistate Tax Compact.

IV

The essential fact is that the Multistate Tax Compact is a substantial agreement between many states. It is called a Compact. It was intended to be a Compact. Approval of the Compact by Congress was con-

templated and sought. It is hardly fitting to say now that it is not a Compact, when it has failed to obtain Congressional approval.

The Multistate Tax Compact may or may not be beneficient and desirable. That is a question which should be resolved only by Congress. Unless and until Congressional approval is given, this Court should determine that the Compact is without validity under Article I, Sec. 10, Clause 3 of the Constitution.

CONCLUSION

This Court should note probable jurisdiction of the appeal.

Respectfully submitted,

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APPENDIX

Appendix A

MULTISTATE TAX COMMISSION ALLOCATION AND APPORTIONMENT REGULATION IV.1.(a), WHICH APPEARS IN THE SEVENTH ANNUAL REPORT OF THE COMMISSION, pp. 64-5.

Prologue.—These Regulations are intended to set forth rules concerning the application of the apportionment and allocation provisions of Article IV of the Multistate Tax Compact. The apportionment rules set forth in these Regulations are applicable to any taxpayer having business income, regardless of whether or not it has nonbusiness income, and the allocation rules set forth in these Regulations are applicable to any taxpayer having nonbusiness income, regardless of whether or not it has business income.

The only exceptions to these allocation and apportionment rules contained in these Regulations are those set forth in Regulation IV.18 pursuant to the authority of Article IV.18 of the Compact.

These Regulations are not intended to modify existing rules concerning jurisdictional standards.

Reg. IV.1.(a). Business and Nonbusiness Income Defined. Article IV.1.(a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation IV.1.(c) for more specific examples of the classification of income as business or nonbusiness income; see Regulations IV.1.(b) and IV.2.(b)(2) for further explanation of what constitutes a trade or business.)

Appendix B

MULTISTATE TAX COMMISSION ALLOCATION AND APPORTIONMENT REGULATION IV.2.(b)(a), WHICH APPEARS IN THE SEVENTH ANNUAL REPORT OF THE COMMISSION, p. 69.

Reg. IV.2.(b)(2). Application of Article IV: Combined Report. If a particular trade or business is carried on by a taxpayer and one or more affiliated corporations, nothing in Article IV or in these regulations shall preclude the use of a "combined report" whereby the entire business income of such trade or business is apportioned in accordance with Article IV.9. to IV.17.

Appendix C

UNITARY BUSINESS INFORMATION SCHEDULE, WHICH APPEARS IN THE SEVENTH ANNUAL REPORT OF THE MULTISTATE TAX COMMISSION, p. 57.

We will ask for a schedule of affiliates plus the following information as to each entity:

(a) Date Acquired
(b) Date Merged, Dissolved or Sold
(c) Percent of Ownership or Control
(d) State of Incorporation and Date of Incorporation
(e) Names of Officers and Directors by Corporation and Year
(f) Nature and Description of Principal Business Activity
(g) Location of Operations
(h) Manner in which Products are Marketed
(i) Location of Accounting Records

We are going to ask for a description of the connection which existed during the audit period between the parent and the subsidiaries and among the affiliated subsidiaries themselves. The description furnished should include:

A. The extent to which operations are unitary as evidenced by centralized (in each relationship indicate the "from" corporation and the "to" corporation):

(1) Management;
(2) Operational Supervision;
(3) Accounting;
(4) Purchasing;
(5) Advertising;
(6) Insurance;
(7) Financing;

(8) Physical Facilities;
(9) Research and Development Activities;
(10) Preparation and Payment of Taxes;
(11) Legal Services;
(12) Sales Force;
(13) Public Relations;
(14) Employee Benefits;
(15) Budget Preparation; and
(16) Equipment Leasing.

B. The extent of unitary use of:

(1) Centralized Executive Force
  (a) Board of Directors
  (b) Officers;
(2) Interaffiliate Transfer of Personnel (Disclose Job Descriptions and Job Titles);
(3) Master Contracts for Common Customers;
(4) Tradenames and Trademarks;
(5) Common Patents; and
(6) Government Contract Negotiators.

C. An explanation of any product similarities.

D. The amounts of total sales or business done and the amounts of sales to and from affiliated corporations, by year and products involved.

E. The extent to which any of the aforementioned unitary features are evidenced by service charges or royalty and license or other payments, showing the year and the amounts from and to the respective corporations.